AN EVALUATION OF ACCOUNTING CONCEPTS THROUGH CASE STUDIES

by

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ABSTRACT

This thesis evaluates fundamental accounting concepts, presentations, and special issues through case studies completed under the direction of Dr. Victoria Dickinson. The cases cover a wide range of topics, including decision-making through financial analysis, tax policies for multinational companies, and common practices and regulations for research and development. Also, the studies compared US GAAP to other prevalent accounting standards recognized across the world. The extensive reviews allowed for exploration into the technology innovations that are shaping the future of public accounting.

The cases were evaluated throughout the fall of 2017 and spring of 2018. Dr. Dickinson administered the case study material and outside material was obtained through academic databases.

Through critical analysis of these concepts, presentations, and issues a deeper understanding of the world of accountancy was obtained. I am now more prepared to enter the field of accountancy and have a better understanding of pressing matters that will be encountered in the future.

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Home Heaters Inc.
Eads Heating Inc. vs. Glenwood Heating Inc.

EXECUTIVE SUMMARY

The two companies being evaluated sell home heating units in two separate towns in Colorado. Glenwood Heating Inc. is located in Colorado Springs; and Eads Heating Inc. is located in Eads. Both companies had identical transactions throughout the year; however the respective managements of each company handled a few of the transactions differently. Glenwood estimated their uncollectable accounts at one percent; while, Eads estimated their uncollectable accounts at five percent. Costing methods also varied between the companies. Glenwood implemented a FIFO costing system, and Eads used a LIFO system. Eads also depreciated one of their three long-term assets by using a double declining balance method. The two companies most noticeable difference arose from their acquisition of a piece of equipment. Glenwood entered into a rental agreement and agreed to pay sixteen thousand dollars this year; however, the owner of the equipment did not promise that the price for the equipment would stay the same next year. Eads entered into an eight-year capital lease agreement for the equipment that is valued at ninety-two thousand dollars.

Investors looking to enter the home heating business should evaluate Figure (1-1&2) to determine which company is a safer investment.

Figure 1-1

Glenwood Heating Inc. Balance Sheet As of 12/31/20X1					
Assets			**Equity**		
Current Assets			Common Stock		160,000
Cash	$	426	Retained Earnings		69,542
Accounts Receivable		99,400	**Total Equity**	$	229,542
Allowance for Bad Debts		(994)	Total Liability &Equity	$	642,632
Total Current Assets	$	98,832			
Long Term Assets					
Inventory		62,800			
Land		70,000			
Building		350,000			
Accumulated Depreciation-Building		(10,000)			
Equipment		80,000			
Accumulated Depreciation-Equipment		(9,000)			
Total Long Term Assets	$	543,800			
Total Assets	$	642,632			
Liabilities					
Current Liabilities					
Accounts Payable	$	26,440			
Interest Payable		6,650			
Total Current Liabilities	$	33,090			
Long Term Liabilities					
Notes Payable		380,000			
Total Liabilities	$	413,090			

Figure 1-2

Eads Heating Inc. Balance Sheet As of 12/31/20X1				
Assets			**Equity**	
Current Assets			Common Stock	$160,000
Cash	$	7,835	Retained Earnings	47,315
Accounts Receivable		99,400	**Total Equity**	$207,315
Allowance for Bad Debts		(4,970)	**Total Liabilty & Equity**	$703,765
Total Current Assets		102,265		
Long Term Assets				
Inventory		51,000		
Land		70,000		
Building		350,000		
Accumulated Depreciation-Building		(10,000)		
Equipment		80,000		
Accumulated Depreciation-Equipment		(20,000)		
Leased Equipment		92,000		
Depreciation Expense-Leased Equipment		(11,500)		
Total Long Term Assets		601,500		
Total Assets	$	703,765		
Liabilities				
Current Liabilities				
Accounts Payable		26,440		
Interest Payable		6,650		
Total Current Liabilities	$	33,090		
Long Term Liabilities				
Notes Payable		380,000		
Lease Payable		83,360		
Total LT liabilities		463,360		
Total Liabilities	$	496,450		

ANALYSIS

After reviewing the two companies' balance sheets, it should become clear which company is the safer investment option. The companies appear to have extremely close current ratios, which determines the liquidity of a company. Glenwood has a ratio of 2.9, and Eads has ratio of 3.1. These ratios, however, are misleading because Figure 1-1 reveals that Glenwood only has four hundred and twenty-six dollars in their cash account. Also, recall that Glenwood chose a much less conservative estimate for doubtful accounts than Eads. If Glenwood does not collect ninety-nine percent of its accounts receivables, the company could face serious liquidity issues. On the other hand, Eads has seven thousand, eight hundred and thirty-five dollars in their cash account, and is allowing for five percent of their accounts receivable to go uncollected (Figure 1-2). The Eads management team is evaluating their bad debts much more conservatively, even with an abundance of cash.

Also, Glenwood Heating Inc. faces an uncertainty when evaluating their long-term debts. Because Eads company entered the capital lease agreement; they can accurately predict how much they will spend on their lease equipment for the next eight years, and the liability is visible in the long-term liability section of their balance sheet. Assuming this equipment is also crucial to the Glenwood's operations, the rent expense will be paid for many years to come. Glenwood's agreement with the owner of the equipment is unpredictable in the long run because the owner has the right to raise the rent expense in the future. This long-term expense is neither present on the balance sheet nor predictable; this unknown future expense is worrisome for a company that could already be facing liquidity issues.

It is my opinion the Eads Heating Inc. is a safer investment option than Glenwood Heating Inc.

WHAT I LEARNED

This case proved to me that two companies could have the same volumes of business but can differ in levels of success depending on how their accounts are managed. At first glance, the two companies seem to match up evenly. Glenwood even had a higher net income than Eads; however, because of circumstances that are not visible on the statements, Eads was the better investment choice. I learned the importance of liquidity and recognizable liabilities.

Figure 1-3

Glenwood Inc. Income Statement FYE 12/31/20X1		
Net Sales		$398,500
Less Cost of Goods		-177,000
Gross Profit		221,500
Expenses-		
Bad Debt Expenses	994	
Building	10,000	
Equipment	9,000	
Other Operating	34,200	
Interest Expense	27,650	
Rent Expense	16,000	
Total Expenses	97,844	-97,844
Pretax Income		123,656
Tax Expense		-30,914
Net Income		**$92,742**

Figure 1-4

Glenwood Inc. Statement of Retained Earnings FYE12/31/20X1	
Beginning Retained Earnings	0
Net Income	92,742
Dividends	-23,200
Ending Retained Earnings	$69,542

Figure 1-5

Eads Inc. Income Statement FYE 12/31/20X1		
Net Sales		$398,500
Less Cost of Goods Sold		-188,800
Gross Profit		209,700
Expenses-		
Bad Debt Expenses	4,970	
Building Depreciation Expense	10,000	
Equipment Depreciation Expense	20,000	
Depreciation Exp.-Leased Equipment	11,500	
Other Operating Expense	34,200	
Interest Expense	35,010	
Total Expenses		-115,680
Pretax Income		94,020
Tax Expense		-23,505
Net Income		$70,515

Figure 1-6

Eads Inc. Statement of Retained Earnings FYE 12/31/20X1	
Beginning Retained Earnings	0
Net Income	70,515
Less Dividends	-23,200
Ending Retained Earnings	$47,315

Appendix-A Glenwood Inc.

Figure 1-7

Glenwood
Part A: Recording Basic
Transactions

	Cash	Receivable	Inventory	Land	Building	Equipment	Accounts Payable	Note Payable	Interest Payable
No. 1	160,000								
No. 2	400,000							400,000	
No. 3	(420,000)			70,000	350,000				
No. 4	(80,000)					80,000			
No. 5			239,800				239,800		
No. 6		398,5000							
No. 7	299,100	(299,100)							
No. 8	(213,360)						(213,360)		
No. 9	(41,000)							(20,000)	
No. 10	(34,200)								
No. 11	(23,200								
No. 12									6,650
Balances	**$47,340**	**$99,400**	**$239,800**	**$70,000**	**$350,000**	**$80,000**	**$26,440**	**$380,000**	**$6,650**

Figure 1-7

Glenwood
Part A: Basic Transactions
Continued

	Common Stock	Revenue	Other operating expenses	Dividends	Interest Expense
No.1	160,000				
No.2					
No.3					
No.4					
No.5					
No.6		398,500			
No.7					
No.8					
No.9					21,000
No.10			34,200		
No.11				23,200	6,650
No. 12					
Balance	**$160,000**	**$398,500**	**$34,200**	**$23,200**	**$27,650**

Figure 1-8

Glenwood
Trial Balance- Part A

	Debit	Credits
Cash	$47,340	
Accounts Receivable	99,400	
Inventory	239,80	
Land	70,000	
Building	350,000	
Equipment	80,000	
Accounts Payable		26,440
Note Payable		380,000
Interest Payable		6,650
Common Stock		160,000
Dividend	23,200	
Sales		398,500
Other Operating Expenses	34,200	
Interest Expense	27,650	
Total	**$971,590**	**$971,590**

Figure 1-9

Glenwood Heating, Inc.
Part B: Recording Additional Information

	Cash	Accounts Receivable	Allowance for Bad Debts	Inventory	Land	Building	Accumulated Depreciation Building	Equipment	Accumulated Depreciation Equipment
Balance: Part A	$47,340	$99,400.00	$0	$239,800	$70,000	$350,000	$0	$80,000	$0
Part B (1) Bad Debts			994						
Part B (2) COGS				-177,000					
Part B (3) Depreciation									
Building							$10,000		
Equipment									9,000
Delivery Equipment									
Rental Payment	-16,000								
Part B (5) Income Tax	-30,914								
Balance	$426	$99,400	$994	$62,800	$70,000	$350,000	$10,000	$80,000	$9,000

Figure 1-9

Glenwood Heating, Inc
Part B: Recording Additional Information (Continued)

	Bad Debt Expense	Cost of Goods Sold	Depreciation Expense-Building	Depreciation Expense-Equipment	Rent Expense	Income Tax Expense	Accounts Payable $26,440	Interest Payable $6,650	Note Payable $380,000	Common Stock $160,000
Balance: Part A										
Part B (1) Bad Debts	994									
Part B (2) COGS		177,000								
Part B (3) Depreciation										
Building			10,000							
Delivery Equipment				9,000						
Rental Payment					16,000					
Part B (5) Income Tax						30,914				
Balance	$994	$177,000	$10,000	$9,000	$16,000	$30,914	$26,440	$6,650	$380,000	$160,000

Figure 1-10

Glenwood
Trial Balance- Part B

	Debit	Credits
Cash	$426	
Accounts Receivable	99,400	
Allowance for Doubtful Accounts		994
Inventory	62,800	
Land	70,000	
Building	350,000	
Accumulated Depreciation-B		10,000
Equipment	80,000	
Accumulated Depreciation-E		9,000
Accounts Payable		26,440
Note Payable		380,000
Interest Payable		6,650
Common Stock		160,000
Dividend	23,200	
Sales		398,500
Cost of Goods Sold	177,000	
Bad Debt Expense	994	
Depreciation Expense-Building	10,000	
Depreciation Expense-Equipment	9,000	
Other Operating Expenses	34,200	
Interest Expense	27,650	
Rent Expense	16,000	
Provision for Income Tax	30,914	
Total	**$991,854**	**$991,854**

APENDIX-B Eads Heating Inc.

Figure 1-11

Eads
Part A: Recording Basic Transactions

	Cash	Receivable	Inventory	Land	Building	Equipment	Accounts Payable	Note Payable	Interest Payable	Common Stock	Revenue	Other operating expenses	Dividends	Interest Expense
No. 1	$160,000									160,000				
No. 2	400,000							400,000						
No. 3	-420,000			70,000	350,000									
No. 4	-80,000					80,000								
No. 5			239,800				239,800							
No. 6		398,500									398,500			
No. 7	299,100	-299,100												
No. 8	-213,360						-213,360							
No. 9	-41,000							-20,000						21,000
No. 10	-34,200											34,200		
No. 11	-23,200												23,200	
No. 12									6,650					6,650
Balance	$47,340	$99,400	$239,800	$70,000	$350,000	$80,000	$26,440	$380,000	$6,650	$160,000	$398,500	$34,200	$23,200	$27,650

Figure 1-12

Eads Co.
Trial Balance- Part A

	Debit	Credit
Cash	$47,340	
Accounts Receivable	99,400	
Inventory	239,800	
Land	70,000	
Building	350,000	
Equipment	80,000	
Accounts Payable		26,440
Note Payable		380,000
Interest Payable		6,650
Common Stock		160,000
Dividend		23,200
Sales		98,500
Other Operating	34,200	
Interest Expense	27,650	

Figure 1-13

Eads Heating, Inc.
Part B: Recording Additional Information

	Cash	Accounts Receivable	Allowance for Bad Debts	Inventory	Land	Building	Accumulated Depreciation Building	Accumulated Depreciation for Leased Equipment	Leased Equipment	Equipment	Accumulated Depreciation Equipment
Balance: Part A	$47,340	$99,400	$0	$239,800	$70,000	$350,000				$80,000	
Part B (1) Bad Debts			4,970								
Part B (2) COGS				-188,800							
Part B (3) Depreciation											
Building							10,000				
Delivery Equipment											20,000
Part B (4) Equipment									92,000		
Down Payment	-16,000							11,500			
Part B (5) Income Tax	-23,505										
Balance	$7,835	$99,400	$4,970	$51,000	$70,000	$350,000	$10,000	$11,500	$92,000	$80,000	$20,000

	Leased Equipment	Equipment	Accumulated Depreciation	Accounts Payable	Interest Payable	Note Payable	Common Stock	Bad Debt Expense	Cost of Goods Sold	Depreciation Expense for	Depreciation Expense-
Balance: Part A		$80,000	$0	$26,440	$6,650	$380,000	$160,000				
Part B (1) Bad Debts								4,970			
Part B (2) COGS									188,800		
Part B (3) Depreciation											
Building										10,000	
Delivery Equipment			20,000								20,000
Part B (4) Equipment	92,000										
Down Payment											
Part B (5) Income Tax											
Balance	92,000	$80,000	$20,000	$26,440	$6,650	$380,000	$160,000	$4,970	$188,800	$10,000	$20,000

Figure 1-13

	Lease Payable	Interest expense	Dep exp. for lease
Balance: Part A		$27,650	
Part B (1) Bad Debts			
Part B (2) COGS			
Part B (3) Depreciation			
Building			
Delivery Equipment			
Part B (4) Equipment	92,000		
Down Payment	-8,640	7,360	11,500
Part B (5) Income Tax			
Balance	$83,360	$35,010	$11,500

Figure 1-14

Eads Heating Co.
Trial Balance- Part B

	Debit	Credits
Cash	$7,835	
Accounts Receivable	99,400	
Allowance for Doubtful Accounts		4,970
Inventory	51,000	
Land	70,000	
Building	350,000	
Accumulated Depreciation-B		10,000
Equipment	80,000	
Accumulated Depreciation-E		20,000
Leased Equipment	92,000	
Accumulated Depreciation-Leased Equipment		11,500
Accounts Payable		26,440
Note Payable		380,000
Interest Payable		6,650
Lease Payable		83,360
Common Stock		160,000
Dividend	23,200	
Sales		398,500
Cost of Goods Sold	188,800	
Other Operating Expenses	34,200	
Bad Debt Expense	4,970	
Depreciation Expense-Building	10,000	
Depreciation Expense-Equipment	20,000	
Depreciation Expense-Leased Equipment	11,500	
Interest Expense	35,010	
Provision for Income Tax	23,505	
Total	**$1,101,420**	**$1,101,420**

FINACIAL STATEMENT PRESENATION
Case 2

Molson Coors Brewing Company

EXECUTIVE SUMMARY

Molson Coors Brewing Company is a beer brewing and distribution company that was formed from the merger of Molson Inc. and Adolph Coors Company in 2005. Molson Coors is an international company with large markets in the United States, Canada, and the United Kingdom. In 2013, the company reported a net income of $567.3 million and an operating income of $805.7 million. However, Molson Coors uniquely includes special items, such as impairment or asset related losses, infrequent and unusual items, and restructuring fees in their operating section of their income statement. The entity discloses their reasoning in their notes.

ANALYSIS

Because of the nature of the beer giants business, its possible that these special items could reoccur; therefore, they are recorded in the operating section of the balance sheet. This case helped me better understand how to view and interpret a collection of finical statements. Molson Coors had excellent disclosure in their financial statements. Through their notes I was able to fully interpret their statements. I saw that companies could report items in unusual classifications if the recording is justifiable

WHAT I LEARNED

I learned that excess taxes could be removed from sales when calculating net sales. Molson Coors deducted excess alcohol and excess foreign taxes when calculating net sales for their income statement. Removing theses excess outflows directly from sale helps potential investors, creditors, and lenders determine the company's profitability.

A. What are the major classifications on an income statement?

The major classifications of an income statement include revenues, expenses, gains, and losses. The statement is divided into operating and nonoperation sections. Within the operating section, a company reports all normal revenues and expenses that arise from their key operating activities. The nonoperation section reports other revenues, expenses, gains, and loses. Expenses and losses are subtracted from revenues and gains, on the income statement, to calculate an entities net income.

B. Explain why under US GAAP, companies are required to provide "classified" income statements.

Companies are required by GAAP to present "classified" income statements to assist shareholders and investors in evaluating the economic situation of a companies by standardizing classifications of inflows and outflows of revenues and expenses across industries. The classifications attribute to GAAP's commitment to comparability and understandability in finical statements.

C. In general, why might finical statement users be interested in persistent income?

Persistent income allows finical statement users to evaluate a company's performance over time, while neglecting unusual and infrequent activities that a company may have faced at a given point at time. For example, if a successful company is faced with a loss of inventory because of fire damage, investors can study persistent income to develop a prediction of the company's future.

D. Define comprehensive income and explain how it differs from net income.

Comprehensive income is the change in equity (net assets) of an entity during a period from transactions, other events, and circumstances, from non-ownership sources. It includes all changes in equity during a period except those relating from investments by owners and distribution to owners. Comprehensive acknowledges other inflows and out flows that do not normally flow through the income statement in addition to net income. While, Net income is derived only from all operating and non-operating flows of the income statement

E. The income statement reports "Sales" and "Net sales." What is the difference? Why does Molson Coors report these two items separately?

Sales refer to the revenue gained from the selling of units of a product at a set price. This figure neglects deductions that may occur during the sales process, such as sales returns and allowances, sales discounts, or excess taxes on sales. Molson Coors Brewing Company deducts theses costs, specifically alcohol and shipment taxes, to figure net sales.

F. Consider the income statement item “Special Items, Net” and information in Notes 1 and 8?

i. Molson Coors defines special items as charges incurred and benefits received that are not indicative of core operations.

These items include:

- Infrequent or unusual items
- Impairment or asset related losses
- Restructuring cost and other atypical employee-related costs
- Fees on termination of specific operating agreements and gains/losses on disposals of investments

ii. Molson Coors classifies these items together because they are not normal operating; however, they do contribute to making operations possible. Companies the size of Molson Coors will be faced with transactions similar to these while carrying out their regular operations. These special items are considered an operating expense because it is possible that they could reoccur. I agree with Molson Coors assessment of these items because of the nature of the company. The beer giant is prone to merging with other entities and restructuring agreements, which qualifies these expenses as operating activities.

G. Consider the income statement item “Other income (expense), net” and the information in Note 6. What is the distinction between “Other income (expense), net” which is classified a non-operating expense, and “Special items, net” which Molson Coors classifies as operating expenses?

“Other Income (Expenses)” is classified as a non-operating expense because these income and expenses do not directly contribute to brewing and selling beer. Molson Coors included gains and loses from foreign currency exchanges, facility bridge fees, and gains and loses on sales of non-operating assets. These transactions differ from the “special items, net” classification because they are in no way related to the normal, aggressive operations of the company

H. What is the amount of comprehensive income in 2013? How does this amount compare to net income in 2013?

i. The amount of comprehensive income in 2013 is $760.20. Net Income in 2013 is $567.3

ii. The difference between comprehensive income and net income are revenues, expenses, gains, and loses that do not flow through the income statement. Molson Coors included adjustments from foreign currency, unrealized gains on derivative instruments, and reclassification of derivative loss to income, and pension adjustments.

J. Molson Coors Effective Tax rate income tax expense divided by the pre-tax income. $84 (income tax expense) divided by 654.50 (pre-tax income) which equals 12.8%.

ACCOUNTS RECEIVABLE ANALYSIS
Case 3

Pearson PLC.

EXECUTIVE SUMMARY

Pearson PLC. is an international educational publishing company headquartered in London England. The company conducts business with universities and individuals in more than sixty countries across the world. The education leader had sales of £ 5.6 billion in 2009. Because the Pearson is located in the United Kingdom, the company's finical reports are created in accordance to International Financial Reporting Standards (IFRS).

WHAT I LEARNED

The Pearson case helped me further understand receivable accounts and their respective contra accounts. Credit is a huge tool in today's business environment, and companies realistically will not be able to collect all of their outstanding receivables. Therefore, evaluation methods such as percentage of receivables and aging of debt were created so companies can more accurately predict their expected income, but these allowances must be dealt with properly. Before this case, I was only aware of how allowance for doubtful accounts could affect accounts receivable; however, sales returns and allowances also greatly impacts accounts receivables.

This case also gave me the opportunity to evaluate the financial statements and notes of a company who abides by IFRS standards. I found that the IFRS and GAAP formatting styles are similar however; their terminology can be quite different. IFRS uses the term "provision" instead of GAAP's "allowance." Also the international format refers to bad debt expense as income statement movements. I found IFRS intriguing and look forward to studying the standards in the future.

A. What is an account receivable? What other names does this asset go by?
   Oral promises of the purchaser to pay for goods and services sold. Trade receivables.
B. How do accounts receivable differ from notes receivable?
   Accounts receivables and notes receivables differ in that notes receivables are generally written promises to pay a sum by a specified date. Accounts receivables are usually collected within 60 days, and notes receivables can be both long and short term.
C. What is a contra account? What two contra accounts are associated with Pearson's trade receivables (see Note 22)? What types of activities are captured in each of these contra accounts? Describe factors that managers might consider when deciding how to estimate the balance in each of these contra accounts.
   A contra account is an account that deducts from the balance of an ordinary account. The balance in accounts such as allowance for doubtful accounts (a contra-asset for accounts receivable) are subtracted from the gross accounts receivable balance, yielding a net total. The two contra accounts associated with Pearson's trade receivables are the provision for bad and doubtful debts and provision for sales returns accounts. Factors that management might consider when estimating the balance of the contra accounts are past history and customer performance, the age of the receivables, the volume of sales made during the year, and many other various factors.
D. Two commonly used approaches for estimating uncollectible accounts receivable are the percentage- of-sales procedure and the aging-of-accounts procedure. Briefly describe these two approaches. What information do managers need to determine the activity and final account balance under each approach? Which of the two approaches do you think results in a more accurate estimate of net accounts receivable?
   The percentage of sales method uses a percentage of sales volume of a given period to accurately estimate the uncollectible credit sales for that period. The aging of accounts approach uses the amount of time receivables have been outstanding to estimate the amount of receivables that will not be collected. These estimates are based off of past experiences. For the aging of accounts approach, managers need information regarding the amount of time the receivables have been outstanding, and based on this amount of time what percentages of them need to be estimated as uncollectable. For the percentage of sales approach, managers must know the total sales volume of the current year as well as historical information on past years as to what percentage of these total sales should be estimated as bad debt. We believe that the aging of accounts receivable will yield a more accurate estimate than does the percentage of sales method as the accounts are actively being analyzed based on a characteristic such as time outstanding whereas the percentage of sales method merely lumps all accounts together and estimates based on a single percentage.
E. If Pearson anticipates that some accounts will be uncollectible, why did the company extend credit to those customers in the first place? Discuss the risks that managers must consider with respect to accounts receivable.

The company extended credit to these customers because it believes that the risk of not collecting on account is less than the amount of sales that would be lost if the company only dealt in cash and did not make credit sales. In other words, the risk of not collecting accounts is outweighed by the benefit of the boost in sales when credit is extended. Businesses always run the risk of not collecting when extending credit, especially to new customers with no performance history. Management must allow for this when estimating bad debt prior to the period and make an accurate estimate so that it comes as no shock to the business when a certain amount of receivables are not collected over the period.

F. Note 22 reports the balance in Pearson's provision for bad and doubtful debts (for trade receivables) and reports the account activity ("movements") during the year ended December 31, 2009. Note that Pearson refers to the trade receivables contra account as a "provision." Under U.S. GAAP, the receivables contra account is typically referred to as an "allowance" while the term provision is used to describe the current-period income statement charge for uncollectible accounts (also known as bad debt expense).

   I. Use the information in Note 22 to complete a T-account that shows the activity in the provision for bad and doubtful debts account during the year. Explain, in your own words, the line items that reconcile the change in account during 2009. The exchange differences line item results from Pearson selling internationally and therefore dealing in several different currencies. When these currencies are exchanged for British pounds the rate is not always the same and this year it resulted in a reduction from the provision account. The income statement movement's line item results from the company having an increase in estimated bad debt expense for the following year. The utilized line item results from the actual writing off of accounts throughout the period. Acquisitions through business combination resulted from Pearson acquiring another company and therefore taking on that company's' provision accounts as well.

FIGURE 3-1

Allowance for Doubtful Accounts

	Beginning 72,000,000
Currency Exchange Difference 5,000,000	
	Bad Debt Expense 26,000,000
Bad Debt Writes-offs 20,000,000	
	Acquisition of Bad Debt from Merger 3,000,000
	Ending 76,000,000

II. Prepare the journal entries that Pearson recorded during 2009 to capture 1) bad and doubtful debts expense for 2009 (that is, the "income statement movements") and 2) the write-off of accounts receivable (that is, the amount "utilised") during 2009. For each account in your journal entries, note whether the account is a balance sheet or income statement account.

1) Bad Debt Expense (IS)	72,000,000	
Allowance for Doubtful Accounts (BS)		72,000,000
2) Allowance for Doubtful Accounts (BS)	20,000,000	
Account Receivable (BS)		20,000,000

G. Note 22 reports that the balance in Pearson's provision for sales returns was £372 at December 31, 2008 and £354 at December 31, 2009. Under U.S. GAAP, this contra account is typically referred to as an "allowance" and reflects the company's anticipated sales returns.

   I. Complete a T-account that shows the activity in the provision for sale returns account during the year. Assume that Pearson estimated that returns relating to 2009 Sales to be £425 million. In reconciling the change in the account, two types of journal entries are required, one to record the estimated sales returns for the period and one to record the amount of actual book returns.

FIGURE 3-2

Sales Returns and Allowances

	Beginning 372,000,000
	Estimate 425,000,000
Actual 443,000,000	
	Ending 354,000,000

   II. Prepare the journal entries that Pearson recorded during 2009 to capture, 1) the 2009 estimated sales returns and 2) the amount of actual book returns during 2009. In your answer, note whether each account in the journal entries is a balance sheet or income statement account.

1) Sales Returns and Allowances (BS)	425,000,000	
Allowance for Doubtful Account (BS)		425,000,000
2) Sales Returns and Allowances (BS)	443,000,000	
Accounts Receivable (IS)		443,000,000

III. In which income statement line does the estimated sale returns of 2009 appear?
The estimated sales returns are found in the "Sales" line of the income statement.

TIME VALUE OF MONEY ANALYSIS
Case 4

Wal-Mart Stores, Inc.

EXECUTIVE SUMMARY

Wal-Mart Stores, Inc. has decided to surface and maintain for 10 years a vacant lot adjacent to one of its stores to serve as a parking lot. Management is considering two separate bids involving two different surfaces to cover the 12,000 square yard parking area.

Bid A: A surface that cost $5.75 per square yards to install. The surface will have to be replaced at the end of five years. The annual maintenance cost on this surface will be 25 cents per square yard for each year except the last year. The replacement surface will be similar.

Bid B: A surface that cost $10.50 per square yard to install. This surface will have a useful life of 10 years and will require annual maintenance each year except for the last, at an estimated cost of 9 cents per square foot.

*cost of capital is 9% and maintenance expenditures occur at the end of each year.

To determine which bid Wal-Mart should take, the present value of both alternatives must be known for the 10-year period.

FIGURE 4-1

Bid A:

12,000 X $5.75= <u>69,000</u> ←PRESENT VALUE OF INITIAL COST

We must now find the present value of the future annual maintenance costs.

12,000 X $0.25= 3,000 ← Annual costs (RENTS)

PV= (RENTS) (

PROPERTY, PLANT, AND EQUIPMENT

Case 5

Palfinger AG

EXECUTIVE SUMMARY

Palfinger AG is a manufacturer of hydraulic lifts, loading, and hauling equipment based in Bergheim, Austria. They produce numerous other products including, recycling cranes, telescopic cranes, railway systems, tailgates, and platforms. In 2007, they earned revenues of €695,623 million. They also were the recipients of government grants to fund expansion of their property, plant, and equipment assets. The company reports their financial statements in accordance with the International Accounting Standards.

WHAT I LEARNED

Through this case I became knowledgeable about when an asset should begin being depreciated and how the IAS reclassifies a self-constructed asset once it is complete. Also, I became aware of how IAS record grants given to a company. The standards establish that funds received by the company should be deducted from the carrying value of the asset for which it has been appropriated. This matches funds with the appropriate asset and does falsely record the grants as revenue. I also became aware of the benefits and drawbacks of the double declining balance method and the straight-line method of depreciating an asset. Double declining balance results in a lower book value of assets during early years of their life. This could result in gain on premature disposal of the assets, while straight line depreciation consistently depreciates the asset a constant value throughout its life.

a. Based on the description of Palfinger above, what sort of property and equipment do you think the company has? Palfinger owns many PP&E assets. They must own land to place their factories and store their inventories. The company's factories will be present on their balance sheet as well as the conveyor belts, welding equipment, forklifts, and other heavy machinery that they use to produce their products.

b. The 2007 balance sheet shows property, plant, and equipment of €149,990. What does this number represent? The figure represents the historical cost less depreciation of Palfinger's large, long-term assets such as factories, equipment, and land (land is not depreciated). Also, upgrades and repair cost of the long-term assets are included in this figure.

c. What types of equipment does Palfinger report in notes to the financial statements? Palfinger discloses that they poses machinery and accessories necessary for production of their various industrial products.

d. In the notes, Palfinger reports "Prepayments and assets under construction." What does this sub- account represent? Why does this account have no accumulated depreciation? Explain the reclassification of €14,958 in this account during 2007. This sub-account represents assets that Palfinger is constructing for future use. This account is not depreciated because IFRS has determined that in order for an asset to depreciate, it must be capable of being used. The reclassification of €14,958 represents an asset being complete and moved into the PP&E section.

e. How does Palfinger depreciate its property and equipment? Does this policy seem reasonable? Explain the trade-offs management makes in choosing a depreciation policy. Palfinger uses a straight-line method to depreciate their assets over the course of their useful lives. This is a reasonable method because straight-line depreciation evenly distributes an assets accumulated depreciation and depreciation expense evenly over the life of the assets. This makes accumulated depreciation more predictable on each year's balance sheet; however, the companies using straight-line depreciation do face a trade off. All assets in nature will not depreciate the same amount each year; therefor, straight-line depreciation can often times be unrealistic.

f. Palfinger routinely opts to perform major renovations and value-enhancing modifications to equipment and buildings rather than buy new assets. How does Palfinger treat these expenditures? What is the alternative accounting treatment? Palfinger capitalizes their improvement costs to their assets' value, increasing the carrying value of the PP&E assets on their books. Alternatively, the company could use a substitution approach, if the pre-improvement value of the assets

g. Use the information in the financial statement notes to analyze the activity in the "Property, plant and equipment" and "Accumulated depreciation and impairment" accounts for 2007. Determine the following amounts:

I. The purchase of new property, plant and equipment in fiscal 2007. In 2007, the notes disclose that Palfinger purchased €61,444 worth of new property, plant, and equipment.

II. Government grants for purchases of new property, plant and equipment in 2007. Explain what these grants are and why they are deducted from the property, plant, and equipment account. The government grants are rewarded to Palfinger for the purchase of land, buildings, and plant machinery. They are deducted from the carrying value of the PP&E assets because the International Accounting Standards specifies these grants are to be matched with related costs for which they are intended to compensate.

III. Depreciation expense for fiscal 2007. In 2007, Palfinger was subject to €12,557 of depreciation expenses.

IV. The net book value of property, plant, and equipment that Palfinger disposed of in fiscal 2007. In 2007, Palfinger recorded €12,298 of net PP&E disposals.

h. The statement of cash flows (not presented) reports that Palfinger received proceeds on the sale of property, plant, and equipment amounting to €1,655 in fiscal 2007. Calculate the gain or loss that Palfinger incurred on this transaction. Hint: use the net book value you calculated in part g *iv*, above. Explain what this gain or loss represents in economic terms.

Palfinger record a loss of €10,643 from the disposal of their asset. The company sold the item for item for €1,655 which is less than the €12,298 book value of the disposal.

i. Consider the €10,673 added to "Other plant, fixtures, fittings, and equipment" during fiscal 2007. Assume that these net assets have an expected useful life of five years and a salvage value of €1,273. Prepare a table showing the depreciation expense and net book value of this equipment over its expected life assuming that Palfinger recorded a full year of depreciation in 2007 and the company uses:

FIGURE 5-1

Straight-line depreciation.

	Beginning Book Value	Depreciation Expense	Ending Book Value
Year 1	€ 10,673	€ 1,880	€ 8,793
Year 2	8,793	1,880	6,913
Year 3	6,913	1,880	5,033
Year 4	5,033	1,880	3,153
Year 5	3,153	1,880	1,273

FIGURE 5-2

Double-declining-balance depreciation.

	Beginning Book Value	Double Declining Rate	Depreciation Expense	Ending Book Value
Year 1	€ 10,673	40%	€ 4,269.20	€ 6,403.80
Year 2	6,403.80	40%	2,561.52	3,842.28
Year 3	3,842.28	40%	1,536.91	2,305.37
Year 4	2,305.37	40%	922.15	1,383.22
Year 5	1,383.22	40%	110.00	1,273.00

j. Assume that the equipment from part *i*. was sold on the first day of fiscal 2008 for proceeds of €7,500. Assume that Palfinger's accounting policy is to take no depreciation in the year of sale.

I. Calculate any gain or loss on this transaction assuming that the company used straight-line depreciation. What is the total income statement impact of the equipment for the two years that Palfinger owned it? Consider the gain or loss on disposal as well as the total depreciation recorded on the equipment (i.e. the amount from part *i. i.*). Palfinger would suffer a loss of €1,293 on the disposal of the asset and would cause a decline of net income of the same amount.

II. Calculate any gain or loss on this transaction assuming the company used double-declining- balance depreciation. What is the total income statement impact of this equipment for the two years that Palfinger owned them? Consider the gain or loss on disposal as well as the total depreciation recorded on the equipment (i.e. the amount from part *i. ii.*). Palfinger witness a gain of €1,096.20 on the disposal of the asset. This gain increased net income by the same amount.

III. Compare the total two-year income statement impact of the equipment under the two depreciation policies. Comment on the difference. The double declining balance depreciation method left Palfinger with a gain on disposal because it decrease the book value of the asset to €6,403.80 which is less than the selling price of the asset. The straight-line depreciation method resulted in a higher book value of the asset; therefore, Palfinger suffered a loss on the asset during disposal.

Case 6

Volvo Group

EXECUTIVE SUMMARY

Volvo is a Swedish corporation that supplies commercial vehicles, construction equipment, engines, drive systems, and various aircraft components. The company employs roughly 90,000 employees across the globe. Volvo has production facilities in 19 countries and has experienced sales in 180 countries. Because of Volvo's innovative needs, the company spends nearly 13 billion Swedish Krona in research and development each year. This huge expenditure is accounted for using the International Finical Reporting Standards (IFRS).

WHAT I LEARNED

This case made me aware of the different methods of which GAAP and IFRS accounts for research and development costs. Under GAAP, all research and development costs are expensed to the period in which they are occurred; however, IFRS allows a portion of these costs to be capitalized. The development portion of R&D costs, if it can be easily distinguished from the research portion, is capitalized and amortized over the periods in which the company benefits from the costs. The costs are categorized as an intangible asset and are treated similarly to good will. The development costs are viewed as self-created good will. These differences in cost allocation between GAAP and IFRs must be recognized when analyzing corporations who have high research and development cost and are held accountable to the different standards.

k. The 2009 income statement shows research and development expenses of SEK 13,193 (millions of Swedish Krona). What types of costs are likely included in these amounts? Volvo most likely spends their research and development money on new technology to reduce emissions of car engines. These new technologies will assist Volvo in meeting new emission regulations set by governments and allow the company to continue sales in these markets.

l. Volvo Group follows IAS 38—*Intangible Assets*, to account for its research and development expenditures (see IAS 38 excerpts at the end of this case). As such, the company capitalizes certain R&D costs and expenses others. What factors does Volvo Group consider as it decides which R&D costs to capitalize and which to expense? Volvo capitalizes its intangible assets only for cost that are contributed to a products development phase if the intangible assets demonstrates all of the following.

a) The technical feasibility of completing the intangible asset so that it will be available for use or sale.

b) Its intention to complete the intangible asset and use or sell it.

c) Its ability to use or sell the intangible asset.

d) How the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

e) The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

f) Its ability to measure reliably the expenditure attributable to the intangible asset during its development.

m. The R&D costs that Volvo Group capitalizes each period (labeled Product and software development costs) are amortized in subsequent periods, similar to other capital assets such as property and equipment. Notes to Volvo's financial statements disclose that capitalized product and software development costs are amortized over three to eight years. What factors would the company consider in determining the amortization period for particular costs?

n. Under U.S. GAAP, companies must expense all R&D costs. In your opinion, which accounting principle (IFRS or U.S. GAAP) provides financial statements that better reflect costs and benefits of periodic R&D spending? IFRS standards to account for research and development costs allows companies to capitalize development costs as an intangible asset; however, GAAP specifies that companies must expense all research and development cost. In my opinion, IFRS standards do a better job at recognizing benefits that arise from these costs because a company future cash flow could possibly be altered by adequate research and development.

o. Refer to footnote 14 where Volvo reports an intangible asset for "Product and software development." Assume that the product and software development costs reported in footnote 14 are the only R&D costs that Volvo capitalizes.

   I. What is the amount of the capitalized product and software development costs, net of accumulated amortization at the end of fiscal 2009? Which line item on Volvo Group's balance sheet reports this intangible asset? At the end of 2009, Volvo had a product and software development balance net of accumulated amortization of 11,409. This amount can be found in the second line of Volvo's balance sheet under "intangible assets."

   II. Create a T-account for the intangible asset "Product and software development," net of accumulated amortization. Enter the opening and ending balances for fiscal 2009. Show entries in the T-account that record the 2009 capitalization (capital expenditures) and amortization. To simplify the analysis, group all other account activity during the year and report the net impact as one entry in the T-account.

FIGURE 6-1

Product and Software Development Costs

Beginning 12,381	
2009 Amount Cap. 2,602	
	2009 Amortization 3,126
	Net Impact 448
Ending Balance 11,409	

p. Refer to Volvo's balance sheet, footnotes, and the eleven-year summary. Assume that the product and software development costs reported in footnote 14 are the only R&D costs that Volvo capitalizes.

i. Complete the table below for Volvo's Product and software development intangible asset.

FIGURE 6-2

(in SEK millions)	**2007**	**2008**	**2009**
1) Product and software development costs capitalized during the year	2,057	2,150	2,602
2) Total R&D expense on the income statement	11,059	14,348	13,193
3) Amortization of previously capitalized costs (included in R&D expense)	2,357	2,864	3,126
4) Total R&D costs incurred during the year = 1 + 2 - 3	10,759	13,634	12,669

ii. What proportion of Total R&D costs incurred did Volvo Group capitalize (as product and software development intangible asset) in each of the three years? In 2007, Volvo capitalized 19% of their total research and development cost, and they capitalized 16% and 21% in 2008 and 2009 respectively.

q. Assume that you work as a financial analyst for Volvo Group and would like to compare Volvo's research and development expenditures to a U.S. competitor, Navistar International Corporation. Navistar follows U.S. GAAP that requires that all research and development costs be expensed in the year they are incurred. You gather the following information for Navistar for fiscal year end October 31, 2007 through 2009.

FIGURE 6-3

(in US $ millions)	**2007**	**2008**	**2009**
Total R&D costs incurred during the year, expensed on the income statement	375	384	433
Net sales, manufactured products	11,910	14,399	11,300
Total assets	11,448	10,390	10,028
Operating income before tax	(73)	191	359

I. Use the information from Volvo's eleven-year summary to complete the following table:

FIGURE 6-4

(in SEK millions)	**2007**	**2008**	**2009**
Net sales, industrial operations	285,405	304,642	218,361
Total assets, from balance sheet	321,647	372,419	332,265

II. Calculate the proportion of total research and development costs incurred to net sales from operations (called, net sales from manufactured products, for Navistar) for both firms. How does the proportion compare between the two companies?

FIGURE 6-5

R&D Costs as a % of Net Sales	2007	2008	2009
Volvo	3.77%	4.48%	5.80%
Navistar	3.14%	2.41%	3.83%

From 2007 through 2009, Volvo has spent more on research and development (relative to net sales) than Navistar, despite accounting for their R&D cost differently and amortizing a portion of capitalized expenses each year.

Case 7

IBM Watson

EXECUTIVE SUMMARY

The field of public accounting is currently undergoing some dramatic changes due recent advancements in business intelligence systems. Data processing and artificial intelligence systems are changing the way traditional tasks such as an audit or a tax planning service are done. Mundane labor, that previously consumed much of a professional's time, is now being completed within seconds by new, innovative systems. The working world is using these advancements to become more productive and raising the standard of work quality.

IBM Watson is perhaps the most innovative technology being employed today. The artificial intelligence system has the potential to alter the course of numerous industries, but its application in public accounting could perhaps shift the industry to more of a consultation-based service. The success of an accounting firms future depends on their ability to adapt and implement programs such as IBM Watson.

IBM WATSON

1) Identify the history and purpose of this tool and describe, in general, how it is used to make business decisions. Be specific about what kind of technology platform it uses, etc. and other resources that need to be in place to fully utilize the functionality of the tool.

IBM Watson was developed to read and analyze natural language in unstructured formats. The developers set out to with the goal of creating software that could win on the show Jeopardy!, in turn creating a creating a software that can analyze mass amounts of data and help users answer complicated questions. Watson can be used in numerous business applications. Its features include discovery, translation, risk assessment, and many other practical tools. Watson runs on IBM's Deep QA software and the Apache UIMA framework and requires a cluster of Power 750™ computers and 90 servers.

2) What special skills are needed to use this tool to aid in business decision-making? How might a student yourself gain those skills?

The beauty of Watson is that it eliminates the need for individuals to spend time on extensive research for task and products. Users will not be forced to sift through mountains of data; instead, Users will need to know how to use and apply Watson in their business processes. Students can utilize IBM resources such as Journey and IBM's alternative training paths to learn how the software functions and ways to apply it to their specific fields of interest. For example, if a student wishes to utilize Watson while working on an audit, the student would need to know how to complete a proper audit and also use IBM resources to learn how to use Watson within the process.

3) How, specifically, would you use the tool in the following business settings? Create at least three specific scenarios for each category in which the tool would lead to more efficiency and/or better effectiveness. Be sure to describe what kinds of data your tool would use for each scenario.

a)Auditing

Watson has the ability to change the way audits are conducted. Traditionally, firms test subsets of data to check the legitimacy of clients' balances; however, Watson can test much larger volumes of data. Watson will be able to verify much greater amounts of client data, creating a high quality audit.

When a firm is performing an audit, Watson could be used to compile transaction records into appropriate ledgers. The client's data could be uploaded into the system to create accurate account balances. Essentially, Watson could help build the necessary financial statements to perform an audit.

Watson could be valuable resource for firms performing an audit on an international firm who accounts using IFRS. The system can help to navigate financial statements and flag differences between GAAP and IFRS. Watson has the capability to understand both accounting standards. This tool can help promote commerce in a well-connected world.

b) Tax planning

Recently, H and R Block incorporated Watson into their personal tax filing service. Watson can help tax experts tailor tax forms to their specific clients. Watson can review client data and help locate proper tax deductions. Watson can essentially handle the mundane work of the tax filing process and give tax experts the time to perform higher quality services in other areas.

If a firm is performing tax-planning services for a client, Watson can be an extremely useful tool to combat the ever-changing regulatory environment surrounding tax law and compliance regulation. Using Watson, IBM has created IBM Reg Tech, which monitors changes in regulation and reporting policies. This program would allow me to make more informed suggestions to my client about specific tax planning issues.

IBMs Watson Tax service has the ability to perform numerous tax services abiding by the specific regulations of all 50 states. One unique feature is the system's ability to know each states laws on trusts, wills, and estate planning. Watson can navigate through these complicated matters with ease and allow clients to receive the best tax benefits possible.

c) Financial Statement Analysis/ Valuation/ Advisory

Watson will eventually revolutionize the accounting profession. The system is capable of transforming data into useable financial information and will be an integral part of building financial statements in the future. This will allow professionals to spend more time analyzing the financial statement data and delivering higher quality expertise. This will also allow more time for professional to research and gain insight into up-and-coming technologies, practices, and industries.

Watson has the ability to read and report on performance across an industry. Professionals can use the system to scour financial statements of numerous companies simultaneously in a matter of seconds. This will be useful when professionals wish to compare a company's performance to the industry standard or evaluate a specific sector of the economy.

Professionals will be able to use Watson's Regtech feature when advising clients. Regtech will help professional explain the benefits and negative aspects of business decisions, such as mergers and acquisitions and appropriate ways to report research and development expenses. Watson will be able to ensure regulatory compliance in future business actions.

4)

Future Partner,

IBM's Watson is the future of the accounting profession, and if we wish to stay competitive in he evolving landscape of public accounting we must invest in this powerful tool. Watson is an artificial intelligence system that can process enormous amounts of data, both structured and unstructured and provided cognitive answer to complex questions. The system is continuously updated and can ensure that our practice is providing the most current advise to our client as possible. Watson's Regtech feature will help us ensure regulatory compliance in each state that we perform services in and will eliminate some of the outside legal council we have recently had to hire. Watson will also be able to transform our audit process, taking mundane tasks out of over qualified hands. The possibilities with this product are endless.

Many of our industry leaders are already investing in Watson. KPMG has partnered with IBM to integrate Watson's cognitive thinking technology into their audit process. Also, H and R Block has begun using Watson in each one of their personal tax filing projects. If we don't begin using Watson soon, I fear we will fall far behind in our industry. In the long run, our investment in Watson will prove to be extremely beneficial and will raise the quality of our work to a whole new level.

Best Regards,

Ashton Moody

LONG TERM DEBT

Case 8

Right Aid Corporation

EXECUTIVE SUMMARY

The Right Aid Corporation is the third largest retail pharmacy in the United States. In 2009, the company had nearly five thousand stores open across thirty-one states. They also filled over three million prescriptions, accounting for sixty-eight percent of their total sales. Aside from medication, Rite Aid sales a wide variety of products including beauty aids, house holds items, beverages and a selection of three thousand and three hundred Rite Aid brand products. A company of this magnitude will undoubtedly require debt to continue expanding their operations. This case evaluates Right Aids long term, and their financing agreements on maturities.

WHAT I LEARNED

The case allowed me to gain a greater understanding of how a corporation raises capital. Right Aid uses both secured and unsecured debt and issues numerous notes each year. It is important for Right Aid to distinguish between the current portion of long term notes because it will affect both their short term and long term planning.

A. Consider the various types of debt described in note 11, Indebtedness and Credit Agreement.
    I. Explain the difference between Rite Aid's secured and unsecured debt. Why does Rite Aid distinguish between these two types of debt? Rite Aid's Secured debt is backed by an asset owned by the company; while their unsecured debt is not backed by a asset.
    II. What does it mean for debt to be "guaranteed"? According to note 11, who has provided the guarantee for some of Rite Aid's unsecured debt? Right Aid's subsidiaries provide the guarantee for both their unsecured and secured debt.
    III. What is meant by the terms "senior," "fixed-rate," and "convertible"? A senior bond is a bond that has higher priority in the event that the company goes bankrupt. A fixed-rate bond is a bond that accrues the interest at the same rate over time lifetime of the bond. A convertible

bond is a bond that can be converted by the bondholder into some form of equity.

IV. Speculate as to why Rite Aid has many different types of debt with a range of interest rates. Right Aid structures their debt in various ways to provide the most enticing investment opportunities for investors while maintaining a respectable debt to equity ratio.

B. Consider note 11, Indebtedness and Credit Agreement. How much total debt does Rite Aid have at February 27, 2010? How much of this is due within the coming fiscal year? Reconcile the total debt reported in note 11 with what Rite Aid reports on its balance sheet. At the end of Rite Aid's fiscal year, the company had $6,370,899 in total debt. $51,502 of this amount will mature in the upcoming year.

From the Rite Aid Balance sheet	
Long Term Maturities, less current maturities	$6,185,633
Lease financing obligations, less current maturities	$133,764
Current Maturities of Long Term Debt	$51,502
Total Maturities	$6,370,899

C. Consider the 7.5% senior secured notes due March 2017.

I. What is the face value (i.e. the principal) of these notes? How do you know? The face value of the March 2017note is $500,000. This is can be assumed because there is no amortization of a discount or premium listed.

II. Prepare the journal entry that Rite Aid must have made when these notes were issued.

Cash	500,000	
Notes Payable		500,000

III. Prepare the annual interest expense journal entry. Note that the interest paid on a note during the year equals the face value of the note times the stated rate (i.e., coupon rate) of the note.

Interest Expense	37,500	
Cash		37,500

IV. Prepare the journal entry that Rite Aid will make when these notes mature in 2017.

Noes Payable	500,000	
Cash		500,000

D. Consider the 9.375% senior notes due December 2015. Assume that interest is paid annually.

I. What is the face value (or principal) of these notes? What is the carrying value (net book value) of these notes at February 27, 2010? Why do the two values differ? The face value of this note is $410,000. The carrying value on the notes at February 27, 2010 is $403,308. The numbers differs because these notes sold at a discount.

II. How much interest did Rite Aid pay on these notes during the fiscal 2009? The interest expense for the period is $39,143 and can be used to computed by multiplying the stated rate of the notes by their face value

III. Determine the total amount of interest expense recorded by Rite Aid on these notes for the year ended February 27, 2010. Note that there is a cash and a noncash portion to interest expense on these notes because they were issued at a discount. The noncash portion of interest expense is the amortization of the discount during the year (that is, the amount by which the discount decreased during the year). Rite Aid paid $38,438 in cash to the debt holder, which is computed by multiplying the stated rate of the notes by their face value and subtracting out $705 to be amortized this discount for the period. The amount amortized is calculated by subtracting 2010's unamortized balance by 2009's unamortized balance. The bonds actual interest expense can be used to calculate the true effective interest rate of 9.659% that the notes are subject to.

IV. Prepare the journal entry to record interest expense on these notes for fiscal 2009. Consider both the cash and discount (noncash) portions of the interest expense from part iii above.

Interest Expense	39143	
Discount on Notes Payable		705
Cash		38,428

V. Compute the total rate of interest recorded for fiscal 2009 on these notes.

Effective Interest Rate = Interest Expense /Beginning Carrying Value

9.659%=39143/405,264

E. Consider the 9.75% notes due June 2016. Assume that Rite Aid issued these notes on June 30, 2009 and that the company pays interest on June 30th of each year.

I. According to note 11, the proceeds of the notes at the time of issue were 98.2% of the face value of the notes. Prepare the journal entry that Rite Aid must have made when these notes were issued.

Cash	402,620	
Discount on Notes Payable	7,380	
Notes Payable		410,000

II. At what effective annual rate of interest were these notes issued?
The notes were issued at an effective interest rate of 10.1212%

III. Assume that Rite Aid uses the effective interest rate method to account for this debt. Use the table that follows to prepare an amortization schedule for these notes. Use the last column to verify that each year's interest expense reflects the same interest rate even though the expense changes.

FIGURE 8-1

Date	Cash Payment	Interest Expense	Discount Amortized	Carrying Value
J-09				402,620.00
J-10	39,975.00	40,750.00	775.00	403,395.00
J-11	39,975.00	40,823.57	848.57	404,243.58
J-12	39,975.00	40,909.45	934.45	405,178.03
J-13	39,975.00	41,004.02	1,029.02	406,207.04
J-14	39,975.00	41,108.15	1,133.15	407,340.19
J-15	39,975.00	41,222.83	1,247.83	408,588.02
J-16	39,975.00	41,349.11	1,374.11	409,962.13

IV. Based on the above information, prepare the journal entry that Rite Aid would have recorded February 27, 2010, to accrue interest expense on these notes.

Interest Expense	40,750.00	
Discount Amortized		775.00
Cash		39,975.00

V. Based on your answer to part iv., what would be the net book value of the notes at February 27, 2010? The net book value of the notes on February 27th, 2010 would be $402491 because Rite Aid would have applied two months less of discount amortization to the bond.
775 x 10/12= 648

SHAREHOLDER'S EQUITY

Case 9

Merck Co.

EXECUTIVE SUMMARY

Merck & Co. is a global pharmaceutical company that specializes in research and development for human and health related issues. Merck is headquartered in New Jersey and employs nearly 60,000 people worldwide. The company is publicly traded on both the New York and Philadelphia Stock Exchanges.

WHAT I LEARNED

Because Merck exits as a pubic company, they have to account for a number of different capital structuring issues. Merck pays dividends to their shareholders and also repurchases their own shares of stock. In this case, I evaluated their financial statements for 2006 and 2007. Through these financial statements I learned how purchasing treasury stock and paying dividends affects outstanding shares. Treasury stock decreases the number of shares outstanding which raises the value of each outstanding shares. Also, I learned that issuing dividends decreases the price per share of outstanding stock.

r. Consider Merck’s common shares.

How many common shares is Merck authorized to issue? At the end of 2007, Merck had 5,400,000,000 shares authorized.

How many common shares has Merck actually issued at December 31, 2007? While Merck had 5,400,000,000 shares authorized, on December 31, 2007 the company had only issued 2,983,508,675 shares

Reconcile the number of shares issued at December 31, 2007, to the dollar value of common stock reported on the balance sheet. The par value of Merck’s common stock is $0.01 per share. Therefore the value of the companies issued common stock is 29.8 million. This value can be found on the company's consolidated balance sheet.

How many common shares are held in treasury at December 31, 2007? In 2007, Merck was holding 811,005,791 shares in treasury stock.

How many common shares are outstanding at December 31, 2007? At December 31, 2007 Merck had 2,172,502884 shares outstanding. This can be found by subtracting the number of shares held in treasury stock from the amount of shares outstanding.

At December 31, 2007, Merck's stock price closed at $57.61 per share. Calculate the total market capitalization of Merck on that day. The total Merck's market capitalization as of December 31, 2007 was $125,157,891,100. This is computed by multiplying the market price per share of Merck common stock by total outstanding shares.

c. Why do companies pay dividends on their common or ordinary shares? What normally happens to a company's share price when dividends are paid? Companies pay dividends because it signals to their shareholders that their earnings are genuine. The distribution of dividends usually decreases a company's price per share.

d. In general, why do companies repurchase their own shares? Companies repurchase their own shares of stock for three main reasons. The first being tax incentives for stock sales. Purchasing treasury stock is an efficient way to reward stockholders with excess cash. Another reason why companies purchase treasury stock is to increase earnings per share and return on equity. Companies may also repurchase their own shares to distribute them to key employees as a form of compensation.

e. Consider Merck's statement of cash flow and statement of retained earnings. Prepare a single journal entry that summarizes Merck's common dividend activity for 2007.

Dividend	3,310.70	
Cash		3.40
Dividend Payable		3,307.30

g. During 2007, Merck repurchased a number of its own common shares on the open market.

I. Describe the method Merck uses to account for its treasury stock transactions. Merck uses the cost method to account for treasury stock purchases. Debit the treasury stock account for the market price of the shares at the time of purchase.

II. Refer to note 11 to Merck's financial statements. How many shares did Merck repurchase on the open market during 2007? In 2007, Merck repurchased 26.5 million shares of their own stock.

III. How much did Merck pay, in total and per share, on average, to buy back its stock during 2007? What type of cash flow does this represent? In 2007, Merck spent $1,429.7 million on stock repurchases. This is an investing cash flow.

IV. Why doesn't Merck disclose its treasury stock as an asset? Treasury stock is not an asset because the item Merck is receiving through the repurchase transactions is a portion of their equity. Purchasing treasury stock reduces the amount of shares outstanding, therefore treasury stock is a contra-equity account.

i. Determine the missing amounts and calculate the ratios in the tables below. For comparability, use dividends paid for both companies rather than dividends declared. Use the number of shares

outstanding at year-end for per-share calculations. What differences do you observe in Merck's dividend-related ratios across the two years? What differences do you observe in the two companies' dividend-related ratios?
2007 and 2006 were similar years for Merck; however, the company issued more dividends in 2006. This affected the Merck price per share. The company had a lower price per share in 2006 than 2007

FIGURE 9-1

	2007	**2006**
Dividends Payable	$3,307,300,000	$3,322,600,000
Shares Outstanding	2,172,502,884	2,167,785,445
Net Income	$3,275,400,000	$4,433,800,000
Total Assets	$48,350,700,000	$44,569,800,000
Operating Cash Flows	$6,999,200,000	$6,765,200,000
Year-end Stock Price	$57.61	$41.94
Dividends per Share	$1.52	$1.53
Dividend Yield	2.64%	3.65%
Dividend Payout	100.97%	74.95%
Dividends to Total Assets	0.0684	0.0745
Dividends to operating cash flows	0.4725	0.4911

MARKETABLE SECURITIES

Case 10

State Street

EXECUTIVE SUMMARY

State Street in a financial holding company located in the United States. The firm serves institutional investors, providing both investment services and investment management. Most of the company’s assets are debt securities. In 2012 the company earned a net income of $2,061 million from investments and had a total comprehensive income of $3,080.

WHAT I LEARNED

The case illustrates the complexity of accounting for security investments. The firm’s intention for the securities determines the appropriate accounting practices. State Street records some securities at their face value and others on an amortized cost basis. Unrealized gains or losses on securities are recorded as a part of net income or other comprehensive income, depending on the type of security. On State Street’s balance sheet, the accounts for both available for sale and trading securities are recorded at fair value. Each securities fair value adjustment accounts are combined with the security’s book value.

s. Consider trading securities. Note that financial institutions such as State Street typically call these securities “Trading account assets.”

- In general, what are trading securities? Trading securities are both debt and equity securities of companies that are held for profit by other companies.

- How would a company record $1 of dividends or interest received from trading securities? A company would record dividends and interest received differently depending on the category of security. For a trading security, a company should recognize the cash as dividend/interest revenue.

If the market value of trading securities increased by $1 during the reporting period, what journal entry would the company record?

Fair Value Adjustment-Trading	$1	
Unrealized Holding Gain-Income		$1

t. Consider securities available-for-sale. Note that State Street calls these, “Investment securities available for sale.”

In general, what are securities available-for-sale? Available-for-sale securities are securities that are classified as short term trading securities, but the company does not specifically wish to hold the security until its maturity date.

How would a company record $1 of dividends or interest received from securities available-for- sale? Dividends and Interest received is recorded similarly to trading securities.

Cash	$1	
Dividend/Interest Revenue	$1	

If the market value of securities available-for-sale increased by $1 during the reporting period, what journal entry would the company record? Available-for-sale securities are adjusted to fair value; however, the unrealized holding gain or loss is record in other comprehensive income instead of income.

Fair Value Adjustment-AFS	$1	
Unrealized Holding Gain-Equity		$1

u. Consider securities held-to-maturity. Note that State Street calls these, “Investment securities held to maturity.”

In general, what are these securities? Why are equity securities never classified as held-to- maturity? Held-to-maturity securities are securities that a company purchases and intends to hold until their maturity date. These securities are not adjusted to fair value and are recorded using the amortized cost method. By definition, equity securities cannot be classified as held-to-maturity because ownership in corporations do not have maturity dates.

If the market value of securities held-to-maturity increased by $1 during the reporting period, what journal entry would the company record? There is no journal entry to record an increase in fair value of held-to-maturity securities.

d. Consider the "Trading account assets" on State Street's balance sheet.

i. What is the balance in this account on December 31, 2012? What is the market value of these securities on that date? The balance of the "Trading Account Assets" account at year-end 2012 is six hundred and thirty-seven million dollars. The account is recorded at fair value; therefore, the market price of the account is the same.

ii. Assume that the 2012 unadjusted trial balance for trading account assets was $552 million. What adjusting journal entry would State Street make to adjust this account to market value? Ignore any income tax effects for this part

Fair Value Adjustment- Trading	$85	
Unrealized Holding Gain or Loss-Income		$85

e Consider the balance sheet account "Investment securities held to maturity" and the related disclosures in Note 4.

i. What is the 2012 year-end balance in this account? The year-end balance for Investment securities held to maturity is $11,329 million.

ii. What is the market value of State Street's investment securities held to maturity? The market value for these securities is $11,661 million.

iii. What is the amortized cost of these securities? What does "amortized cost" represent? How does amortized cost compare to the original cost of the securities? The amortized cost of these securities is $11,379 and represents the carrying value of the bond after a portion of the bond is subtracted from the purchase price each period. The amortized cost is lower than the original price.

iv. What does the difference between the market value and the amortized cost represent? What does the difference suggest about how the average market rate of interest on held-to-maturity securities has changed since the purchase of the securities held by State Street? The difference between market price and amortized cost represents a change in interest. The difference suggests that the original stated rate of the security is difference from the effective interest rate the security is subject to.

f Consider the balance sheet account "Investment securities available for sale" and the related disclosures in Note 4.

i. What is the 2012 year-end balance in this account? What does this balance represent? The 2012 year-end balance for the available for sale securities account is $109,682 million. The account its adjusted to its fair value therefor this number represents the fair value of the account.

ii. What is the amount of net *unrealized* gains or losses on the available-for-sale securities held by State Street at December 31, 2012? Be sure to note whether the amount is a net gain or loss. State Street had an unrealized gain of $1,119 million on their AFS securities.

iii. What was the amount of net *realized* gains (losses) from sales of available-for-sale securities for 2012? How would this amount impact State Street's statements of income and cash flows for 2012? State Street realized a gain of $55 million on sales of AFS securities, causing an increase in net income and cash flow from investing activities.

g State Street's statement of cash flow for 2012 (not included) shows the following line items in the "Investing Activities" section relating to available-for-sale securities (in millions): Proceeds from sales of available-for-sale securities $ 5,399 Purchases of available-for-sale securities $60,812

i. Show the journal entry State Street made to record the purchase of available-for-sale securities for 2012.

Debt Security-AFS	$60,812	
Cash		$60,812

ii. Show the journal entry State Street made to record the sale of available-for-sale securities for 2012. Note 13 (not included) reports that the available-for-sale securities sold during 2012 had "*unrealized pre-tax gains of $67 million as of December 31, 2011*." *Hint:* be sure to remove the current book-value of these securities in your entry.

Cash		$5,399	
Unrealized Holding Gain-Equity	$67		
Gain on Sale of Security			$55
Debt Security-AFS			$5,471

iii. Use the information in part *g. ii* to determine the original cost of the available-for-sale securities sold during 2012.

FIGURE 10-1

Debt Security	$5,471	
Gain on Sale of Security		-$55
<u>Unrealized Holding Gain-Equity</u>	<u>-$67</u>	
Original Cost of Security	$5,349	

DEFERRED INCOME TAX

Case 11

ZAGG Inc.

EXECUTIVE SUMMARY

Zealous About Great Gadgets (ZAGG Inc.) is a leader in the mobile device accessory industry. The company began operations in 2005 and sold screen protectors for mobile devices. The company has since developed numerous products for consumers to use with their devices.

ZAGG Inc., like all other entities operating in the United States is subject to both GAAP and IRS standard for recording income. The standards recognize income differently. GAAP reports income on an accrual basis; while, the IRS taxes companies' income on a cash basis. These differences can be both permanent and temporary. If the differences are temporary, either a differed tax asset or liability is created.

v. Describe what is meant by the term book income? Which number in ZAGG's statement of operation captures this notion for fiscal 2012? Describe how a company's book income differs from its taxable income. Book Income is the result of a business's normal operations, reported on an accrual basis. ZAGG's book income can be found on their 2012 Income Statement; their book income for the year was $14,505. Book income differs from taxable income because of differences that arise from current and future tax obligations.

w. In your own words, define the following terms:

-Permanent tax differences (also provide an example): A permanent tax difference is a tax event that will only be accounted for in the period of which it occurs and will not reverse itself. An example of a permanent tax difference would be a change in a stated interest rate.

-Temporary tax difference (also provide an example): A temporary tax difference is a tax event that will be accounted for in current and future periods. An example of a temporary tax difference would be taxes on interest expense that can be deferred to a different period.

-Statutory tax rate: A Statutory tax rate is one that is written and mandated by law.

-Effective tax rate: An effective tax rate is the rate corporations are actually subjected to. It can be found by dividing a corporations tax expense for a period by the corporation’s pretax income for that period.

x. Explain in general terms why a company reports deferred income taxes as part of their total income tax expense. Why don’t companies simply report their current tax bill as their income tax expense?

Under US GAAP and ASC 740, entities must record their income on an accrual basis. This means expenses are recorded as they are accrued. Alternatively, the Internal Revenue Service determines taxable income on a cash basis. Accounting for tax events using the different methods results in differences in finical statement income and taxable income. Therefore a company’s income tax expense for a period will not always match the amount the entities will pay to the IRS.

Often, the tax events create differences in the two finical measures, and the differences can affect multiple periods. These events create either a deferred tax asset of liability. Ultimately, these differences will be the same; however, temporary differences can exist in current periods. Under ASC 740, the income tax expense is derived by changes in deferred tax effects and income taxes payable. Income tax expense still reflects accrual financial income; however, the codification aligns the expense with amounts actually paid.

y. Explain what deferred income tax assets and deferred income tax liabilities represent. Give an example of a situation that would give rise to each of these items on the balance sheet.

As previously mentioned, deferred tax assets and liabilities arise from differences in accrual and cash basis recording methods. An example of an event where a deferred tax liability would be arise would be a sale on account. If a company made a sale and the buyer only paid a portion of the contract price at the time of purchase, income would differ between GAAP and IRS reporting standards. Income for GAAP reporting would be higher because the amount of the entire sell would be recorded. Therefore, income tax expense will be higher than interest tax payable for the period. The difference between the two amounts would be a deferred tax liability.

Deferred tax assets arise from future deductible amounts. The assets are a result of revenue being reported under IRS standards that would be recorded at a later date under GAAP standards. For instance, a pending legal liability would cause GAAP income to be lower than IRS income because the IRS would not recognize the expense.

e. Explain what a deferred income tax valuation allowance is and when it should be recorded. A deferred income tax valuation allowance is an account that can be found on a company's balance sheet to adjust a companies deferred tax assets to a realizable amount. This account is recorded if an event takes place that changes the amount a corporation expects to benefit from a differed tax asset.

f. Consider the information disclosed in Note 8 – Income Taxes to answer the following questions:

I. Using information in the first table in Note 8, show the journal entry that ZAGG recorded for the income tax provision in fiscal 2012?

Income Tax Expense	9,393	
Deferred Tax Asset, Net		8,293
Income Tax Payable		17,686

II. Using the information in the third table in Note 8, decompose the amount of "net deferred income taxes" recorded in income tax journal entry in part *f. i.* into its deferred income tax asset and deferred income tax liability components.

Income Tax Expense	9,393	
Deferred Tax Asset	8,002	
Deferred Tax Liability	291	
Income Tax Payable		17,686

III. The second table in Note 8 provides a reconciliation of income taxes computed using the federal statutory rate (35%) to income taxes computed using ZAGG's effective tax rate. Calculate ZAGG's 2012 effective tax rate using the information provided in their income statement. What accounts for the difference between the statutory rate and ZAGG's effective tax rate? ZAGG's effective tax rate is 39.3%. The differences in interest rates may be the results of varying interest rate in different states and permanent and temporary differences arising from deferred tax assets/liabilities.

REVENUE RECOGNITION

Case 12

Apple Inc.

EXECUTIVE SUMMARY

Apple Inc. is one of the most recognizable brands in the world. Their logo is often associated with industry shattering innovation and sleek product design. Apple designs, manufactures, and markets personal computers, smart phones, and portable devices. The company also operates a digital music purchasing sight and streaming service.

This case examines how Apple embraced and implemented the new revenue recognition standards put in place by ASC 606. The new standards accept revenue recognition only when there has been a change in assets or liabilities, once a service obligation has been completed. These guidelines reduce the amount of estimates used to compute the amount of revenue that should be recognizes once a transaction occurs; however, Apple faced the issue of multiple-element contracts because many of their products are bundled with other services

z. In your own words, define “revenues.” Explain how revenues are different from “gains.” Revenues are inflows of cash through normal operations or return on some investments. Revenues differ from gains in that gains arise from events that take place outside the normal routine of daily operations.

aa. Describe what it means for a business to “recognize” revenues. What specific accounts and financial statements are affected by the process of revenue recognition? Describe the revenue recognition criteria outline in the FASB’s Statement of Concepts No. 5. When a business recognizes revenue, it recognizes proceeds from a completed service obligation. The income statement is most greatly affected by the recognition of revenue because revenue from normal operations is reported there. Under the new revenue recognition principal set out in ASC 606, businesses are to recognize revenue on an asset-liability approach. This means that a company is to recognize revenue as transactions change the balance of their assets and liabilities. The criteria for the new revenue recognition standards are listed below.

-Identify contract with customers

-Identify separate performance obligations within the contract

-Determine transaction price

-Allocate the transaction price to the separate performance obligations

-Recognize revenue when each performance obligation is satisfied

bb. Refer to the Revenue Recognition discussion in Note 1. In general, when does Apple recognize revenue? Explain Apple's four revenue recognition criteria. Do they appear to be aligned with the revenue recognition criteria you described in part b, above? Apple recognizes revenue on product sales when title and risk of loss is transferred to the customer. Apple's four revenue recognition criteria is as follows:

-Persuasive evidence of an arrangement exists

-Delivery has occurred

-The sales price is fixed or determinable

-Collection is fixed and determinable

Apple's criteria is mostly aligned with ASC 606; however, specific performance obligations are not identified after it is determined a contract exists.

cc. What are multiple-element contracts and why do they pose revenue recognition problems for companies? Multiple-element contracts are contracts that contain multiple service obligations in one transaction. The new revenue recognition standards eliminated many of the traditional metrics used to record revenue. The new methods require an "estimated selling price" that is calculated by using a stand-alone price for each obligation. This is somewhat contradictory to the goal of ASC 606 because it relies on estimates to recognize revenue.

dd. In general, what incentives do managers have to make self-serving revenue recognition choices? Management performance is usually measure by analytical data of the departments they serve. Therefore, promotions, bonuses and other forms compensation can be directly correlated with their department's success. This encourages managers to manipulate estimates to show a more favorable departmental performance.

ee. Refer to Apple's revenue recognition footnote. In particular, when does the company recognize revenue for the following types of sales?

I. iTunes songs sold online.

Songs sold on the iTunes store do not belong to Apple; they belong to a third party who maintains the risk of the property after the sale. Therefore, Apple only recognizes their net commission of the sales price of each song.

II. Mac-branded accessories such as headphones, power adaptors, and backpacks sold in the Apple stores. What if the accessories are sold online?

Apple is the sole owner of their Mac-brand inventory because they posses the title and risk of ownership of the items. On in store purchases, the company recognizes revenue as at transaction because the customer immediately assumes title and risk of ownership. For online purchases, there is a delay between the transaction and the recognition of revenue because Apple still holds the risk of ownership during transit.

III. iPods sold to a third-party reseller in India.

Similar to online sales of Apple brand products, revenue is recognized when the third party takes ownership of the iPods; however, Apple may still have a performance obligation if this was a multiple- element contract. Revenue from future obligations should be recorded once they are satisfied.

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